

Drafting and Negotiating Controversial Contract Clauses

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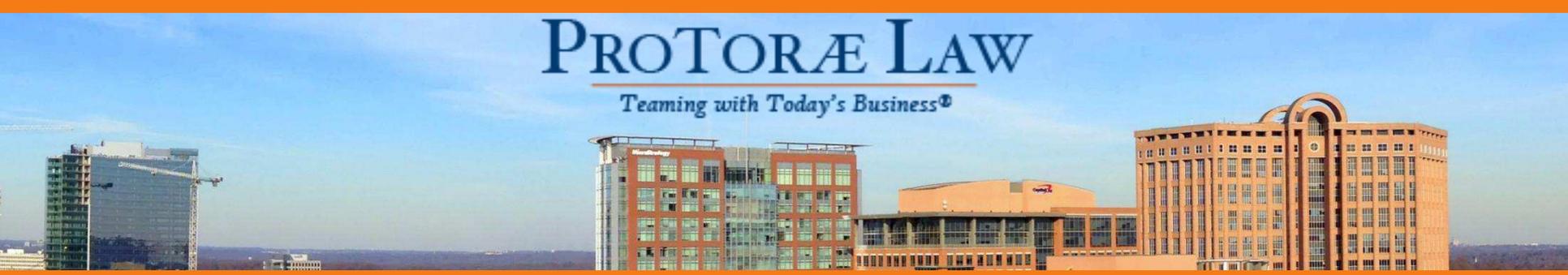


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Formerly a partner at an international law firm, Devon Hewitt has over 20 years' experience in representing small, mid-tier and large government contractors. Ms. Hewitt's practice includes the review of prime contracts, subcontracts, nondisclosure, non-compete, consultant, supplier and licensing agreements, in addition to litigation and compliance. She has participated in over 100 bid protests and is one of the few attorneys to have appeared before GAO in formal hearings and argued bid protest appeals before the United States Court of Appeals for the Federal Circuit. Ms. Hewitt is a graduate of Smith College and the University of Virginia School of Law. Ms. Hewitt clerked for the Honorable Jose Fuste in the U.S. District Court for Puerto Rico.

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Litigation

Beth Staples

Beth Staples is dedicated counsel to Hughes' Defense and Intelligence, and State and Federal Government practices. Ms. Staples has over 20 years' experience representing engineering, outsourcing, and consulting contractors. Beth's experience in government contracting includes negotiating custom development and other service agreements, bid protests, FOIAs and CRADAs. Prior to joining Hughes, Ms. Staples served as managing counsel for TLT-Babcock, Inc., and as division counsel for Ernst & Young. Beth received her B.A. from the University of California, Santa Cruz, her JD from Cleveland-Marshall College of Law, and her LLM in Intellectual Property from the University of Akron School of Law.

Introduction

- Contracts and contract clauses are a risk shifting device
- Risk should be allocated to party that can best avoid the risk or to the party that can best insure against the risk
- Risk shifting often reflects bargaining power
- Negotiating risk-shifting clauses reflects analysis of risk vs. reward; context important

Risk-shifting Clauses

- Indemnification
- Limitation of Liability
- Representations and Warranties
- Intellectual Property/IP Indemnification

Indemnification Clause

- Most powerful way of allocating liability to one of the contracting parties
- Most complex and misunderstood
- Presentation will focus on indemnification clauses in context of Government prime contracts and subcontracts
 - Unique concerns with M&A transactions/Consumer contracts/Design-Build contracts/Healthcare

Govt's Indemnification Responsibility

- Generally, Government cannot agree to indemnify a prime contractor because such an indemnification runs afoul of the Anti-Deficiency Act, 31 U.S.C. § 1341, and the Adequacy of Appropriations Act, 41 U.S.C. § 11.
- DOJ Opinion dated November 15, 2012 re web services contract
 - Open-ended, unrestricted indemnification obligation violates the Anti-Deficiency Act because it represents an amount *in excess* of appropriated funds
 - May also constitute a violation of the Appropriations Act as it represents an obligation for payment of monies due *in advance* of appropriations
 - Violations of the ADA must be reported to the President, Congress and GAO
 - Government employees found to have violated the ADA are subject to administrative discipline, “knowing and willful violators” could face criminal penalties
- OMB Guidance issued April 4, 2013

Govt's Indemnification

Responsibility: FAR Interim Rule

- Issued June 21, 2013
- Clarifies that any legal agreement that includes a clause requiring the Govt. to indemnify a contractor *that constitutes an ADA violation* is unenforceable against the Govt.
 - If amount of Government's liability can be ascertained at time contract is executed *and* agency has budget authority to cover liability, then indemnification clause does not violate ADA
 - ✓ Insurance Deductibles/Cost of insurance
 - ✓ Capped Liability
- Does not apply if exception is expressly authorized by statute and specifically authorized under applicable agency regulations and procedures
 - Public Law 85-804 - indemnification permitted "to facilitate the national defense"
 - ✓ FAR 52.250-1, Indemnification Under Public Law 85-804
 - Price Anderson Act - NRC/DOE may indemnify owners/operators of nuclear plants from claims resulting from nuclear incidents

FAR 52.228-7, Insurance - Liability to Third Persons

- Included in cost contracts (other than construction and A/E contracts)
- Contractor entitled to be reimbursed for the cost of insurance expressly required for and allocable to contract
- Contractor can also be reimbursed for any uninsured liability to third persons arising out of contract performance
 - But subject to the availability of appropriated funds at the time contingency arises
 - Cannot be “flowed-down” to subs w/o Govt. consent

Indemnification Clause: Content

- Identity of the Indemnitee/Indemnified Party
- Obligations of Indemnitor (defend, indemnify or hold harmless)
- Scope of Obligation (i.e., the events that give rise to the indemnification obligation)
- Triggers (at what time does the indemnification obligation arise?)
- The types of losses or expenses for which the indemnitor is liable
- Exclusions/Limitations/Qualifiers

Sample Indemnification Clause

(Prime Contractor Friendly)

Subcontractor shall indemnify and hold harmless Prime Contractor and its directors, officers, employees, agents, stockholders, affiliates, subcontractors and customers from and against all allegations, claims, actions, suits, demands, damages, liabilities, obligations, losses, settlements, judgments, costs and expenses (including without limitation attorneys' fees and costs) which arise out of, relate to or result from any act or omission of Subcontractor.

Indemnification: Identity of Indemnitee

- Indemnitee – typically drafted very broadly to include parties in addition to the contracting parties
 - Typically includes indemnitee and indemnitee’s directors, officers, and employees
 - ✓ Revise as appropriate for LLC, partnership etc.
 - ✓ Stockholders vs. shareholders etc.
 - Should not include affiliates or customers
 - ✓ If affiliates or customers included could constitute unintended third-party beneficiaries of contract
 - May include indemnitee’s successors, heirs and assigns
- Should it be mutual?

Indemnitor Obligations

- Indemnification obligation often grouped with an obligation to “defend” and to “hold harmless”
- Distinct and different obligations
 - *Indemnity* requires indemnitor to reimburse indemnitee for loss or damage
 - ✓ Arise when there is an incurred liability, i.e., judgment at the end of a case
 - *Duty to defend* requires indemnitor to pay the costs of preparing/defending lawsuit, whether or not it has merit; immediate obligation
 - *Hold harmless* provision means that indemnitor cannot sue indemnitee for harm contemplated by clause
 - ✓ Releases indemnitee from liability to indemnitor; exculpatory clause

Obligation to Defend

- Obligation imposed immediately, prior to indemnification
- More extensive obligation than indemnity obligation because duty to defend does not depend on outcome of claim
- Clause should include any right or obligation of the indemnitor to defend the third party claim, including the sole authority to select counsel
- Clause should address degree to which indemnitor may settle third-party claims without consent of indemnitee
- Clause should address obligation of indemnitee to give indemnitor notice of third party claim in writing once indemnitee aware of claim
- Clause should address indemnitee's obligation to provide reasonable assistance in defending/settling claim

Obligation to Hold Harmless

- General view that an obligation to “hold harmless” is synonymous with “indemnify”
- Some courts distinguish obligations – see “hold harmless” as an exculpatory provision
 - Releases indemnitee from suit for wrongdoing by indemnitor
 - May encompass consequential damages
- Try to eliminate phrase from clause

Scope of Indemnification Responsibility

- Bodily Injury/Harm
- Damage to Personal/Tangible Property
- Patent/Copyright Infringement
- Errors, acts and omissions (professional services)
- Violation of law
- Breach of Contract/Product Defects
- Breach of Representations/Warranties
- **“any damage or loss”**

Indemnification Clause: Triggers

- Direct vs. Third Party claims
 - Make sure parties under control of indemnitee excluded; if considered “third parties” then third-party claim is really direct claim
- When does indemnification obligation arise?
 - Damages/Losses/Costs – payment due once indemnitee incurs an actual loss
 - “Liabilities” is broader – indemnification obligation arises when liability fixed or established
 - May affect applicability of statutes of limitations for indemnity obligation
 - Include definition of “Loss” or “Claim”

Types of Losses

- Usually includes final judgments and settlements
- Can include litigation expenses and attorneys' fees
 - Insert “reasonable”
 - Attorney's vs. attorneys' fees
 - Prime may want to specify types of “costs”, i.e., filing, consultant, expert witness and accountants' fees

Limiting Exposure

- Cap to the extent of insurance coverage
- Floor/Ceiling (Nickel and Dime/Basket)
- Exclude indirect, consequential or special damages
- Exclude losses resulting from indemnitee's negligence, gross negligence or willful misconduct
- Exclude payments made by insurance or third party
 - *See FAR 52.228-7, Insurance, Liability to Third Parties*
- Qualifiers

Indemnification Clause Considerations

- Relationship to Limitation of Liability Provision
- Relationship to Reps/Warranties
- Relationship to Force Majeure provision
- Relationship to Insurance provision
- Make sure indemnification provision survives expiration or termination of the contract

IP Indemnification Clauses

- IP supplied by Supplier to Buyer infringes Third Party IP rights requiring Buyer to stop using IP or pay for right to use IP
- Sample Buyer- Friendly Clause

Seller will defend, indemnify, and hold Buyer harmless against any allegation that any intellectual property provided to Seller hereunder infringes a copyright or patent or misappropriates a party's trade secret.

IP Indemnification Clauses: Scope

- Applies to any “allegation of infringement” or “action, suit or proceeding” and/or “losses incurred”
- Applies to any IP used/provided or only to a “Deliverable”
- Geographic limitations
- Include claims for copyright infringement, misappropriation of trade secrets *and* patent infringement?
 - Difference between copyright/trade secret and patents

IP Indemnification

- Exclusions
 - Deliverable modified by someone other than Seller
 - Deliverable modified by the Seller in accordance with Buyer's specifications or instructions
 - Deliverable combined with other IP
 - Geographic Limitations
- Remedial Measures
 - Substitution of non-infringing or modified product that meets functionality of Deliverable
 - Purchase of right to use

Patent Indemnities

- FAR § 52.227-1, Authorization and Consent
 - Protects contractors and subcontractors using third-party patents to perform work for the Govt
 - Required “flow-down” clause
 - Not = to indemnification by the Govt; = affirmative defense
- FAR § 52.227-3, Patent Indemnity
 - Contractor indemnifies Govt. against liability for infringement of a U.S. patent

IP Indemnity – Relationship to Warranties

- UCC – general warranty against infringement of third-party property right
- Can undo narrowly drafted indemnification responsibility
- Should disclaim UCC warranties – explicitly
- Should also refuse to include general representation against infringement
 - And indicate sole remedy for breach is per indemnification clause

Limitation on Liability Clauses: Types

- Limit liability by excluding types of damages available for recovery
 - *See FAR 52.212-4, Contract Terms and Conditions – Commercial Items – see subsection (p)*

Except as otherwise provided by an express warranty, the Contractor will not be liable to the Government for consequential damages resulting from any defect or deficiencies in accepted items

- Limit liability by limiting total amount of damages available for recovery (cap)

Types of Damages

- Direct damages/ general damages
 - Damages “arising naturally” from a breach
- **Consequential/special damages**
 - Damages caused by a breach but “unnatural” in that they are due to the special circumstances of non-breaching party
 - In order to be recoverable, damages must have been foreseeable at time of contracting
 - Does not equal remote or speculative damages; consequential damages are “proximate”
 - ✓ Remote or speculative damages not recoverable for contract breach, even w/o a consequential damage waiver

Types of Damages cont.

- Incidental damages
 - Costs incurred by non-breaching party in finding substitute performance/mitigating damages
- Indirect Damages
 - Consequential and incidental damages
- **Lost Profits**
 - Can be direct damage or consequential damage
- Punitive/Exemplary damages
 - Damages are designed to punish wrongdoer, not to compensate non-breaching party; usually applies in tort actions
 - Not applicable to contract actions

Exclusions of Damages

- Consequential damages and loss profits typically excluded
 - But not always the same type of damages
- Analyze in context
 - Prime or sub
 - Other exclusive/specific remedies provided in contract
 - Flow-Downs/Order of Precedence

Liability Caps

- Compensation/fees paid under the contract or some multiple of same
- An agreed upon amount of money (a.k.a. liquidated damages)
 - Must approximate actual damages or will be considered a penalty
- Available insurance coverage
- Combination of two or more of the above

Limitation of Liability Clauses: Enforceability

- Sale of Goods- Governed by Uniform Commercial Code
 - §2-719 allows parties to a contract to limit remedies available unless unconscionable (unsophisticated consumers)
 - Debate as to when a specific remedy fails its “essential purpose” whether contract exclusion of consequential damages applies or non-breaching party can rely on UCC remedies
- Services - Common law
 - VA, MD and DC uphold limitation on liability clauses as long as not unconscionable or contrary to public policy
- Generally cannot limit liability for gross negligence, fraud or intentional misconduct, but may be able limit liability for non-breaching party’s own negligence if intent to do so clear

Limitation of Liability Clauses: Considerations

- Relationship to Indemnification clause
- Relationship to Arbitration clause
- Relationship to Reps/Warranties
- Make sure clause survives expiration or termination of contract

Warranties

- Referenced in FAR 52.246-7001 through 7010
- Provides a contractual right for the correction of defects notwithstanding any other requirement of the contract pertaining to acceptance
- Warranty is a stated period of time or use, after acceptance by the government, where the government may assert a contractual right for the correction of defects

Warranties: Govt. Perspective

- Addresses government and contractor rights and responsibilities and risk allocation
- Use of warranty is NOT mandatory
- Protects government from defects in deliverables for a stated period from delivery or acceptance
- Approval for inclusion of warranty is required unless there is a commercial item, technical data, or fixed-price contract with QA provisions FAR 246.704

Warranties: Content

- Factors considered in scope of warranty
- Specific remedies available for breach
- Exceptions to warranty coverage
- Triggers

Warranties: Use and Scope

Factors the government will consider when negotiating scope - FAR 46.703:

- Nature and use of supplies or services
 - Complexity and function
 - Degree of development
 - State of the art
 - End use
 - Difficulty in detecting defects before acceptance
 - Harm to government if the item is defective
- Cost of warranty
 - Contractor's additional charge to assume risk of deferred liability
 - Government cost of administration and enforcement

Warranties: Use and Scope cont.

Factors the government will consider when negotiating scope – FAR 46.703:

- Trade practice
 - Where an item is customarily warranted in the trade
 - The cost of the item will be the same to the government
- Reduced government contract quality assurance requirements

Specific Remedies Available

FAR 46.706(b)(2)

- Standard remedies
 - Equitable adjustment of the contract
 - ✓ Prime and subcontractor not likely to negotiate this quickly
 - Direct the contractor to repair or replace defective items at the contractor's expense
- Alternate remedies
 - Retain defective item and reduce the contract price
 - Arrange for repair/replacement by the government or third-party, at the contractor's expense
 - ✓ May create competitive concerns for the contractor
 - ✓ The government may require "in place" repair materials

Remedies

- In and out costs
- Transportation costs – regardless of FOB point
- The government expects inclusion of labor and materials costs to:
 - Reinspect items the government believes will be defective
 - Test, package, pack, and mark items repaired/replaced

Exceptions to Warranty Coverage

- Failure to give prompt notice
- Damage caused by misuse or negligence
- Where warranty only covers certain aspects to a contractor-provided item or service
- Where the government specifies the design of the end item, the contractor's warranty covers material, workmanship, or failure to conform to specification
 - Avoid fitness for particular purpose or implied warranties
 - Watch FAR 46.706(b)(1)(ii): If the government does not specify the design, warranty may extend to usefulness of the design

Warranty Triggers

- Warranty claim independent of, and applies after acceptance by the government
- A claim arises where a defect in the deliverable occurs during the stated warranty period
 - “Defect” = Any condition or characteristic in any supply or service “not in compliance with the requirements of the contract” FAR 52.246.701
- Applicability of warranty does not negate claims against the contractor for:
 - Latent defects
 - Fraud
 - Gross mistakes amounting to fraud FAR 46.705(b)

Subcontract Challenges

- Warranty against IP Infringement
 - Subcontractor should provide IP infringement indemnity only – not a warranty against IP Infringement
 - Remedies for infringement should be subcontractor's sole obligation
 - Warranty as to compliance with all laws
 - ✓ Should be fixed as to effective date
 - Warranty as to no possible 3rd party infringement
 - ✓ Requires contractor to police the patent landscape & take an offensive approach to IP infringement

Warranty Drafting Comments

- Subcontractors usually in defensive mode
 - Request reciprocal warranties from Prime
 - Carve out IP Infringement language and treat separately
 - ✓ Specify that modification to make non-infringing or purchase of license sole remedy
 - ✓ If Subcontractor can't do either, refund of pro-rata purchase price
 - ✓ Defense of infringement managed by Sub
 - Avoid letting Prime lead any defense or settlement

Intellectual Property Clauses

- Primary focus is data rights
 - License rights in “technical data” and “computer software”
- Risk allocation in IP clauses is based on standard rights allocation linked to source of funding for development
- A contractor or Sub must assert pre-existing/independently developed rights – or risk the government receiving broader rights than necessary

Govt. Rights Under Govt. Funded Contract

- FAR 52.227-7013 – 7015 requires a contractor to:
 - Identify in advance what is the pre-existing technical data or computer software that will be included in deliverables
 - ✓ FAR 52.227-7017 is the format required for disclosure of a contractor's or its subcontractor's background IP
 - ✓ The form allows for specification of limitations of government rights to technical data and restrictions on government use of computer software

Intellectual Property: Key Terms

- Technical data: FAR 52.227-7013
 - Any recorded information of scientific or technical nature
 - ✓ Includes computer software documentation
 - ✓ Items protected under patent, copyright, know-how, trade secret, or other forms of IP protection
- Computer software: FAR 52.227-7014
 - Includes executable code, source code, design details, and processes and materials enabling reproduction, recreation, and/or recompilation of software

Ownership and Standard License Rights

- Where government funding is involved, the contractor usually retains ownership, subject to specified license rights to the government
 - **Government-funded development:** The government gets unlimited rights
 - **Mixed funding:** Government gets government purpose rights
 - **Privately Funded by Contractor:** Government gets restricted rights in noncommercial computer software and limited rights in noncommercial technical data

Scope of License Rights

- **Unlimited rights:** Use, modify, reproduce, release, or disclose ... in any manner, for any purposes, and to have or authorize others to do so
 - ✓ Allows the government to make derivatives and enhancements without royalty obligation
 - ✓ Allows disclosure that may compromise a contractor's technology to its competitors
 - ✓ Allows third parties to access and use to compete
- **Government purpose rights** (where there is a mix of government funding and contractor funding)
 - ✓ Allows use, disclosure, release, modification, or reproduction of TD or CS within the government and under government cooperative agreements with international defense organizations
 - Excludes use for commercial purposes
 - ✓ Limitations expire after 5 years and become unlimited rights
 - A contractor may specify a different expiration

Scope of License Rights cont.

- **Restricted rights:** Computer software
 - The Government can use the software with one computer at one time
 - Allowed to make a backup copy
 - Can allow other parties to use to correct deficiencies
- **Limited rights:** Technical data

Patents

- Covered under 252.227-7038
 - Provides the Contractor with option to retain title to any invention (worldwide rights)
 - ✓ Contractor must provide notice to Gov't within certain timeframes or risk loss of option rights
 - ✓ Gov't gets **non-exclusive**, non-transferable, irrevocable, paid-up license to practice (or have 3rd parties practice) subject invention worldwide

Other IP Rights Considerations

- Commercial vs. noncommercial items
 - Noncommercial TD and CS are covered under 52.227-7013 and 7014, respectively
 - ✓ Is the item sold or offered for sale to the public?
 - ✓ Watch TD and CS incorporated into an item or service that is being customized for government
 - ✓ Commercial item covered under 52.227-7015 and 7037
 - ✓ Watch situation where research or testing using Contractor's Technical Data is used in some form and test reports are the deliverable to the Prime or Govt.
 - Test report is commercial item
 - Technical Data or Computer software utilized for test is not

Other IP Rights Considerations cont.

- Prime as an unintended beneficiary
 - If a contractor is sub to a Prime, flow-down clauses may be modified by the Prime to receive more rights, warranties, and indemnities from the sub
 - ✓ Watch license grants that provide broad rights to Prime rather than directly and solely to government
- Custom license restrictions
 - Where Government Purpose Rights (GPR) are specified due to mixed funding, consider proposing the following modifications
 - ✓ No sunset of restrictions after 5 years
 - ✓ Allow the government to share TD or CS with FFRDCs, but require consent for other third parties

IP Rights at Termination

- What rights vest with Gov't or Prime if Termination for Convenience?
 - ✓ Sub should require full payment and performance of contract by Prime before IP rights vest.
 - ✓ Watch out for ownership claim of work in progress / work for hire
 - ✓ Confirm any IP that is in Gov't or Prime hands is controlled through license restrictions that survive termination

IP License Risk Management

- Amending data rights restriction listing
 - Track what licenses are in place
 - Audit internally where development or project deliverables have moved or changed
 - Revisit your data rights disclosure under 52.227-7017 for accuracy
 - ✓ Amendment allowed for new or additional background IP that is in scope 52.227-7017

Thank You

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